23 January 2019

Inflation Grinding Higher, At Heart

- **Q4 CPI up 0.1%, keeping annual at 1.9%**
- **Slightly above market, slightly below RBNZ**
- **But point is that core inflation is robust/rising**
- **Questioning (dogged) market view of OCR cuts**
- **We keep with our OCR view of stable-to-up**

Imaginings that New Zealand's inflation was losing its way were put to bed by this morning's December quarter CPI report. Sure, it registered an increase of just 0.1%. But that was suppressed by seasonality. More instructively, the annual rate of CPI inflation stayed at 1.9% in Q4. And the core measures that Statistics NZ published were running at least as strongly as this.

The market was expecting a flat result for the Q4 CPI, for an annual 1.8%, as were we. One of the surprises for us was that petrol prices fell only 0.6% and that there was no discernable dent to outpatient services prices in Q4, with the government's increased subsidy for GP visits that began 1 December. The latter might simply mean the negativity accumulates into Q1.

Not that we see strong reason to adjust our expectation for the Q1 CPI. Indeed, that remains at 0.3% inflation for the quarter, which would set annual inflation at 1.7%. Beyond that, we still point out the likelihood of annual CPI inflation running a bit below 2.0% this year. However, above all, we continue to highlight the robust trajectory of underlying inflation, which should mean headline inflation is underpinned over a longer sweep.

Of course, the Reserve Bank anticipated a 0.2% increase in the Q4 CPI, for 2.0% on the annual. While the outturn didn't quite make that, it was hardly far away.

Consumers Price Index - 2018 Q4

	Actual	Mkt Pick	Nov MPS	Q3
CPI - qtly % chg	**+0.1**	flat	+0.2	**+0.9**
CPI - ann % chg	**+1.9**	+1.8	+2.0	**+1.9**
Non-tradables qtly % chg	**+0.7**		+0.4	+0.8R
Non-tradables ann % chg	**+2.7**		+2.6	+2.5R
Tradables qtly % chg	**-0.4**		-0.1	+0.9R
Tradables ann % chg	**+0.9**		+1.0	+1.0R

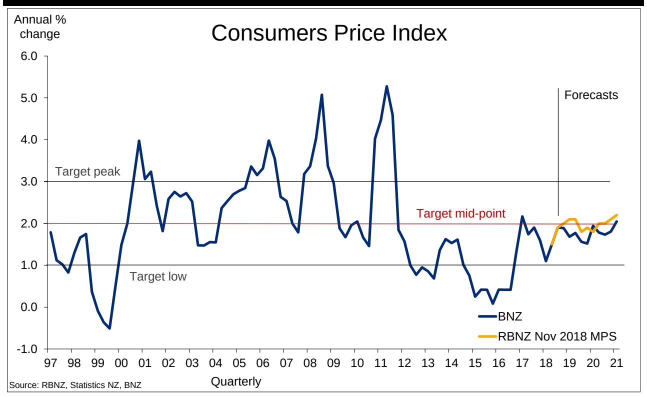
More to the point, the RBNZ anticipated a 0.4% increase in the non-tradables CPI, whereas it actually lifted 0.7% (or +0.8% seasonally adjusted, according to Statistics NZ estimates). This took annual inflation in non-tradables to 2.7%. And from a Q3 result that was revised down to 2.5%, from 2.6% (on account of corrected allocation from the accommodation services line in the CPI).

Bottom line: non-tradables was a fair chunk stronger than the Bank anticipated. And non-tradables inflation is the part of the CPI the Bank has historically looked to, to get a better sense of purely domestic inflation.

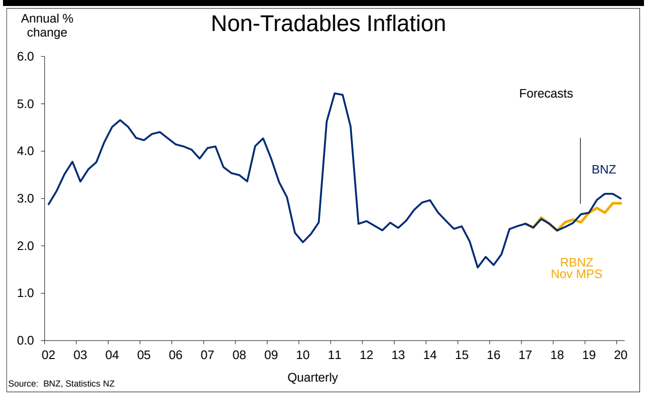
Tradables inflation has been the part that has long frustrated the Bank. This is partly because it couldn't and can't do anything about international inflation, which has been running relatively low for a while, or commodity price gyrations. And that the RBNZ could have little sustainable influence in the NZ dollar. And so it continues, with tradables prices slipping 0.4% in Q4, making for annual inflation of 0.9%.

But returning focus to core inflation, we note that, along with strength in non-tradables, there was a strong pulse running through the core inflation measures that Statistics

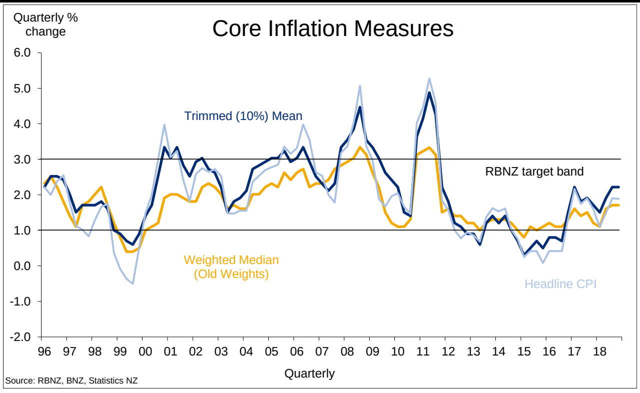
Still To Watch



Echoes of the RBNZ Upside Scenario



Firming Up



NZ produces. Annual inflation in the trimmed-mean measure, for example, was running at 2.1% in Q4, while the weighted-median was 2.2%. Granted, their quarterly results weren't that strong, at 0.3% and 0.1% respectively. But we tend to downplay these, as they can be relatively noisy (potentially affected by residual seasonality and other distortions on a quarterly basis).

For more on underlying inflation, we'll be interested to see what the RBNZ comes up with in its sectoral factor model of inflation (due 3:00pm). Recall that this was 1.7% y/y in Q3. We would guess a slight pickup for Q4. But then we said that last time, only for its annual inflation to stay at 1.7%. Also watch for any revisions to recent history, however, as occasionally occurs.

Our outlook for CPI inflation, especially on a core basis, is underpinned by our view that the economy is extremely stretched – for physical capital and labour. While aggregate demand might not be expanding strongly, it's enough to be putting a lot of pressure on aggregate supply.

This message, importantly, remained in full force in last week's NZIER Quarterly Survey of Business Opinion. With this, we should expect GDP growth to struggle from here, but for inflation pressure to remain. Others might interpret slow-looking GDP growth as an open invitation for more monetary "stimulus", we admit.

Market reaction to this morning's CPI was interesting. Going into the number we detected more edginess from those abroad than those on NZ shores. This was portrayed in the polls, at least, with expectations appearing relatively softer amongst those domiciled overseas than locally.

In any event, there was a response to the outcome. And this was no doubt to the core inflation messages in the Q4 CPI, rather than just the fact its headline outcome proved slightly stronger than the market's median expectation.

NZD jumped about 35 pips, to 0.6755, not long afterwards. NZ wholesale interest rates increased, but mainly at the short end, and by around 3 to 4 basis points (further out it was more of a wash). Even so, this left the market still pricing a small chance of a rate cut over the near term, and increasing odds of this transpiring as one looks ahead. While this might be market positioning around something turning sour internationally, we think it has little justification based on New Zealand's current economic position and outlook.

Barring an international capitulation, there remains a lot about the NZ economy that promises to press inflation higher. And that's notwithstanding the many headwinds that are blowing in its face, from abroad.

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